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The Credit Crisis – Looking ahead

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

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Good morning Ladies & Gentlemen,

When I went to Brussels a little over four years ago I was told by everyone that the fifth year would be quiet. We would all be in wind-down mode. The depth and seriousness of the global financial market difficulties has certainly put paid to that.

There is no shortage of analyses of what went wrong in the world's capital market over the past eighteen months. But what is clear is that it was no one thing but a rather complex set of relationships, interactions, events, and omissions on the part of many different actors.

In the case of legislators, I am convinced that over the years there has been too much "regulatory capture" by the sell side of the financial services market: Their lobbies have been strong and powerful. By contrast there has been too little engagement on the buy side. That is an imbalance that legislators must be much more conscious of.

A second problem for regulators, supervisors, and indeed, credit rating agencies was the pressure on the availability of adequate resources.

A common problem across all markets was that when the investment banking markets were booming – and money was no object for the private sector seeking to attract top talent – regulators and supervisors found it difficult to get the budgets and the resources to keep up with innovation - or to police the markets. For the future, Member States will have to commit the necessary resources to ensure that oversight of risk management in financial institutions is more robust. It must be subject to much more detailed and frequent hands-on supervisory inspections. In Europe crisis management mechanisms must be put in place to manage the deeply integrated nature of our capital markets with 80 per cent of Europe's banking assets held in cross-border banking groups.

A third problem – of particular relevance in the case of banks, risk managers, and traders – is misaligned incentives. Incentive structures have been overwhelmingly aligned to short term performance rather than performance through the cycle. In most of those firms where this was most pronounced there has been complete destruction or massive dilution of shareholder value. And there has been, as a consequence, the imposition of a wholly unacceptable long term burden on taxpayers. Privatizing the profits of banks and socializing the losses is not acceptable in a democratic society. A fundamental overhaul of the regulatory and supervisory structure is an imperative and the structure and timing of performance pay in banks must be more closely aligned to long term shareholder interests and financial stability.

Incentives for brokers and credit rating agencies have been even more perverse. In the United States, brokers were selling mortgages without any interest in checking whether the borrower had the means to repay. They had no stake beyond the immediate. Financed via SPVs, the mortgages were parcelled up in debt packages and securitized entities in which neither originators or sponsors retained any material long-term stake but paid credit rating agencies to award a nice little ribbon marked AAA. When the packages were unwrapped, most of what was inside consisted of pools of toxic assets in respect of which there was no proper due diligence, no evidence of capacity to repay, and little cushion to cope with a market downturn.

That's why I have included much tougher measures in the revised Capital Requirements Directive proposal which will require thorough independent due diligence on securitizations, proper cashflow sensitivity analysis, and less reliance on issuer pay, conflicted credit rating agencies. Originators or managers of these securitizations will be required to retain a meaningful stake in each tranche of the securitization issue. I was pilloried from the rooftops about this proposal when I originally put it forward. I am now glad to see that this principle has been put forward at the G30 level. Some banking industry lobbyists have sought to put down amendments in the European Parliament at the behest of their sell-side investment banking members - that would totally neuter the proposal's effectiveness. More irresponsibly still, they have sought to undermine a requirement for adequate due diligence on securitization positions prior to investing – with a form of wording that would make it virtually impossible for supervisors to monitor compliance.

Mortgage assets and leveraged loans originated in huckster shops, carved up and buried in "CDO squareds" (that is securitizations wrapped in other securitizations), with progressively more obscure, more contingent, and more complex orders of priority for the allocation of cashflows have, in my view, no place in the capital markets. The opaqueness, the lack of transparency, the wholly unnecessary complexity, and the near impossibility of undertaking independent due diligence on the underlying risks assets in these particular structures before investing have undermined trust in the securitization market. Financial institutions - and their trade bodies - who have been so vigorously opposed to meaningful reform are doing themselves no favours at all. Is it any wonder that the valuation of securitized investments has become so challenging? Is it any wonder that mark to market valuation on securitized assets has become either so meaningless, or so depressed, or both? Is it any wonder that the securitization market itself has seized up? Far from restoring the trust and confidence so much needed for recovery - those banking federations who have lined up to table "wrecking amendments" are not serving to help recovery of trust in the capital markets but rather to underpin the distrust that is now embedded within them. If successful, they will impair the re-opening of a once transparent, responsible, and vibrant securitization market – a market that, if properly managed, can contribute meaningfully to sustainable, long-term economic growth.

I turn now to accounting standards and capital requirements. These have also exacerbated the markets' recent problems because of rules that are "pro-cyclical". When market liquidity becomes tight as of now - sales decisions and valuations based on the so-called 'mark-to-market value' reinforce the downward spiral: They result in further forced sell-offs, which in turn reinforce and amplify the falls in mark-to-market prices. That is why I recently brought forward a measure to provide firms with more flexibility on the mark to market requirements and to facilitate asset transfer from the trading to the banking book.

Dynamic provisioning served many banks well in the past. In this turmoil it has served the Spanish banks well and I would like to see a return to it more broadly. A system that introduces significant counter-cyclical, requiring banks to build up more substantial buffers in good times so that they can let them run down in bad times, makes sense not only from a micro viewpoint – reducing the risk of bank failure – but from a macro viewpoint too: It serves to restrain excessive expansion during booms. And it reduces the likelihood of a much diminished capital base in recessionary times which makes it more difficult for banks to lend, thereby preventing the kick-starting of sustainable recovery.

Ideally, we should get international agreement on such a revised regime and I will be pushing for it. This issue aside, I have never been persuaded that capital requirements on trading books should be materially lower than for those on banking books. The fact is that when liquidity dries up trading becomes impossible without a very sharp discount. While the probability of default might be lower on a trading book because of the shorter time during which the assets are held, the impact of default when it happens is the same whether the asset has been held for a single day on the trading book or a whole decade on the banking book. I therefore intend to bring forward, in due course, much tougher capital requirements for trading book exposures.

As to value-at-risk models, suffice to say that we now have incontrovertible evidence they are very useful when they don't matter and totally useless when they do matter. I am convinced that we need an overall cap on leverage on bank balance sheets regardless of risk asset weightings or value at risk measurements. The fact that equity to asset ratios are currently averaging out at about 3 per cent tells you everything you need to know about the inadequacy of the current pro-cyclical capital requirement framework. In the current climate it is impossible to measure the valuation of many financial assets to an accuracy of 3 per cent, and leverage of more than 30-to-1 will be a thing of the past in any revised framework that I approve.

Some say that the storm of the financial crisis is subsiding. I am not so sure - share prices continue to be volatile. On the positive side, interbank lending rates are slowly coming down but are still far higher than they should be. Conditions in global markets remain fragile.

But more worryingly, we are seeing the effects on the real economy right across Europe, in the United States and now further afield. GDP is contracting. Industrial production is falling at a record fast pace.

So where do we go from here? The answer is that we have to rebuild trust. That is the core challenge for Europe, for the Commission, for global leaders and for the industry over the next five years. It will not be easy.

In October 2007, we persuaded ministers to adopt a roadmap for action. Most of the elements that I have set out today were included.

We need healthy financial markets. Without them, we will not recover. But we also need – and are getting - changes in the way that those markets are regulated.

We need to ensure transparency and adequate risk management. Measures on this are part of my proposal on capital requirements.

We need more work on accounting standards.

I have also commissioned work on Credit Default Swaps to strengthen market infrastructure.

We need adequate oversight and crisis management. This is why I am bringing forward a paper on Early Intervention and waiting for the analysis of the High Level Group of experts working under Jacques de Larosière, with the report due at the end of this month.

And finally, we need international cooperation. I have been a strong backer from the start of the G20 initiative. We need reform of the international financial institutions and adequate monitoring and surveillance mechanisms. We need to work together in the bad times, not just the good ones.

We need to strike a balance between regulation to correct the failings we have witnessed on the one hand and preserve dynamic and innovative markets on the other. What we do not need are vast forests of reports every week going to supervisors who appear to devote ample resources to ensuring they arrive on time but fewer on interpreting the content and drawing the relevant conclusions. What we do not need is to become captive of those with the biggest lobby budgets or the most persuasive lobbyists: We need to remember that it was many of those same lobbyists who in the past managed to convince legislators to insert clauses and provisions that contributed so much to the lax standards and mass excesses that have created the systemic risks. The taxpayer is now forced to pick up the bill.

We have seen huge sums of taxpayers money committed to bail out the banks and other sectors. More will no doubt be needed to unblock lending to the private sector. Prime Ministers and their Finance Ministers will be trying to get the best value for this money. Perfectly laudable. But there has been a growing trend to impose conditionality on such Government aid. Requiring banks or companies to use the money, for example, to support the domestic economy at the expense of others. This is a classic beggar thy neighbour approach. It's a example of the type of short term political reaction that will stir up protectionism as well as creating new barriers in our internal market. The US listened to fears that were expressed by the EU and others in regards to the 'Buy America' provisions in their economic stimulus package. They made it clear that any such measures had to be in compliance with their international obligations in the WTO and elsewhere. My colleagues Neelie Kroes, Cathy Ashton, and I, through our respective competences for competition, state aid, trade, and internal market will work with fellow Commissioners and Member States to ensure that any national measures taken by Member States in the EU will be in compliance with our EU Treaty and international obligations.

We must also bear in mind the massive scale of debt that governments everywhere must raise to finance bank bail outs and to stimulate their economies to prevent recession turning to depression. This looks certain to put significant upward pressure on government bond yields in the years ahead. Those governments that are seen to be taking decisive, speedy, and effective action to curb borrowing, and lay the basis for sustained future recovery will be given priority in the long queue for international capital. Those governments by contrast who are slow to act - or slow to tackle structural deficits - risk getting trampled all over.

Ireland has come under the spotlight in the international financial press in recent times with much of the criticism unjustified and unbalanced. This country starts out with a very low debt to GDP ratio. We have a substantial national pension reserve fund. Over a reasonable adjustment period we can, and I believe we will manage our deficit back down to sustainable levels but some very unpopular and unpalatable decisions over the next number of years will be necessary.

I am confident that with the appropriate focus on strengthening our sources of competitive advantage we can get our economy back on a renewed path of strong growth and rising living standards over the medium term and can benefit from the upturn in the global economy following the rather painful correction that economies everywhere are now going through.

Thank you very much.